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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 001787

SIPDIS

STATE FOR E, P, EUR/SE AND EB
TREASURY FOR U/S TAYLOR AND OASIA - MILLS
NSC FOR FRIED, QUANRUD AND BRYZA

E.O. 12958: DECL: 09/02/2006
TAGS: ECON PREL TU
SUBJECT: RESTORING CONFIDENCE IN TURKEY'S ECONOMY - BACK TO
BASICS

Classified by Ambassador W. Robert Pearson for reasons 1.5
(b,d).

¶1. (C) This is an action request. See paragraph 6.

¶2. (C) The Turkish Government has put itself in a precarious financial situation on the eve of war with Iraq. To get the economy on even fragile ground, it needs to implement strong reforms. Unfortunately, it has shown no inclination to do so. It has not finalized the letter of intent with the IMF nor moved forward on key reforms in that letter. It has not passed the full-year 2003 budget. It did not pass a parliamentary resolution authorizing U.S. troops, which would have unlocked our aid. As a consequence, nominal interest rates on Turkish lira debt are moving upward, now at 67 percent. The possibility of reaching the average annual interest rate at which Turkey's debt is sustainable this year, 45 percent, looks increasingly remote. Real interest rates on lira debt are currently 33 percent, again not sustainable for long, given the short maturity of much of this debt.

¶3. (C) The Government may/may have bought itself three weeks in the debt market, by raising \$2 billion in the March 18 auctions. It facilitated these auctions by incorrectly assuring markets of the availability of the full U.S. package. The next large-scale debt service comes on April 9 (a total payment of TL 5.2 quadrillion or about \$3 billion), and Treasury will build up its cash reserves during March, a major tax collection month. But raising several billion dollars more in the markets will be hard.

¶4. (C) Market analysts here differ on whether the Government has three weeks to restore some confidence and thereby scrape together another \$3 billion debt payment. While there may be three weeks to avoid a GOT debt payment failure, continuing sharp lira depreciation could panic enough Turkish bank customers to cause a run on banks, triggering the Government's GOT's 100 percent guarantee of all bank liabilities (which it wouldn't have cash to honor).

¶5. (C) In our view, the GOT needs to implement a strengthened program of reforms immediately, and thereby shift focus back towards its own reform efforts. This program is supported by at least \$3 billion of potential IMF and World Bank disbursements over this year. As a practical matter, the existing program will have to be revised following the outbreak of hostilities, since it does not account for this scenario. The result - which will need to be reached very quickly - would provide an opportunity to take action to bolster market confidence through steps such as:

-- Surprise market on the upside by signing a revised LOI that includes further fiscal saving measures beyond the 6.5 percent of GNP primary surplus (thus creating more resources to meet debt payments).

-- Announce an accelerated schedule of 2003 privatizations to include money earners like THY, Erdemir and TEKEL (each of these have major foreign investor interest, per investment bankers.)

-- Implement now further structural reforms beyond the existing commitments, focusing on major market impact issues, especially: announce further lay-offs and restructuring of the state enterprises.

¶6. (C) Embassy requests instructions; we would plan to

deliver a demarche to Deputy PM and FM Gul, bypassing
MinState Babacan as much as possible.

¶7. (C) Even if the GOT engages in this kind of major campaign, its ability to avoid the worst case scenarios is not assured. Restoration of market confidence may be too gradual and incremental to meet upcoming needs. According to some analysts, only a U.S. commitment of financial assistance will suffice to restore confidence over the next three weeks.

Others are more optimistic, and believe that Turkish banks even at this date are still interested in supporting credible GOT efforts. All agree, however, that bold reform "back to basics" steps are essential, even if as some believe they may be not sufficient.

PEARSON